



Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

Miller gives pension reform testimony

With adequate public pension reforms, Oklahoma government could “live within its means without balancing its books on the backs of future generations,” State Treasurer Ken Miller said as he testified before the Senate Pension Committee during an interim study on improving the systems.

In his remarks, delivered on October 16, Miller outlined two major pension reform goals Governor Fallin introduced last legislative session.

He gave a broad overview of problems with the structure of the current systems

and detailed two steps to modernize the plans and realize millions in savings – while keeping all promises to current state workers, teachers and public safety employees.

Miller detailed the benefits of changing from the current defined benefit systems to defined contribution systems for non-public safety workers hired in the future. He also spelled out savings that could be realized by unifying the boards and administration of the seven systems.

He also responded to false and misleading claims made by opposition

groups. “What I find unfortunate is when opposition groups attack individuals and motives rather than the merits. I also find it unfortunate when rumors are spread as fact and misinformation is purposefully disseminated to elicit a negative response and engagement.

“Such inaccuracies serve to instill unnecessary fear and undermine the public trust. Further, it is an insult to the intelligence of their own group members,” he said.

The complete text of Treasurer Miller’s comments are published in this edition.

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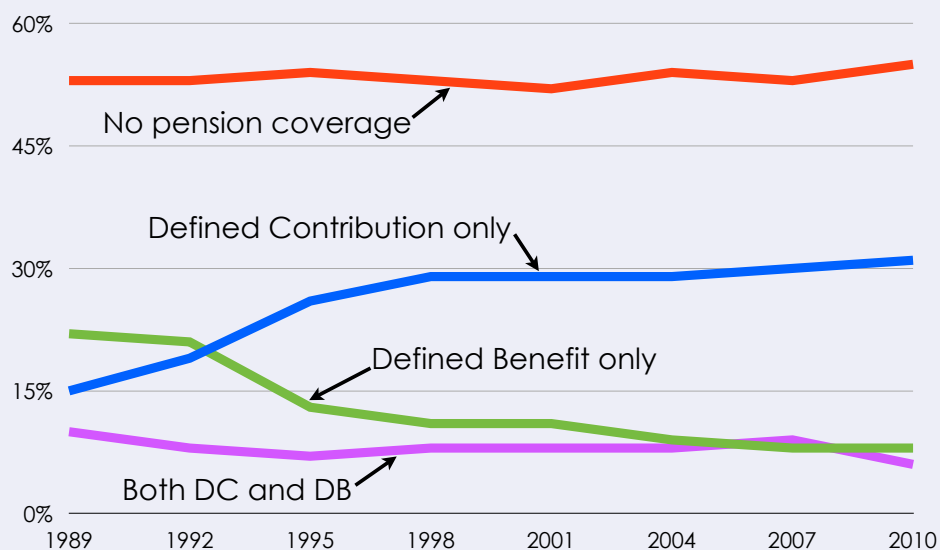
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U.S. Workers’ Pension Coverage



Source: Boston College Center for Retirement Research & U.S. Federal Reserve Survey of Consumer Finances



Testimony of Ken Miller, Oklahoma State Treasurer, Oklahoma State Pension Commission Chairman

Before the Oklahoma State Senate Pension Committee

Study on Potential Improvements to the State Pension Systems

Delivered October 16, 2013

Mr. Chairman and members of the committee, I thank you for the opportunity to address this committee on the need for further pension reforms.

I would like to begin by affirming that I view our police, firefighters, teachers, and the many others who provide essential public services in areas such as health and human services, transportation and our justice system, as my partners in service to our constituents.

I see Oklahoma's state pension plans as a promise that must be kept to 220,000 current employees and retirees while making sure future employees are provided a fair yet affordable retirement system that meets the needs of a changing public sector. So, I agree with the coalition formed to oppose pension reform that all promises made to employees and retirees must be kept. That is why any plan design change that will receive my support must only affect future workers, i.e. those not yet employed by the state, municipalities and school districts.

As Oklahoma's duly elected chief financial officer, State Pension Commission chairman, and a former budget chairman in the House, I believe I bring a unique perspective to this hearing and one that is sure to be quite different than those of the various opposition groups that will testify later today. In fact, I feel a bit like Gordon Gekko going to a shareholders' meeting.

The main reason for the differing perspectives should be self-evident. I, like you, was entrusted by our constituents with a fiduciary duty to work in the best interest of the entire state and all its constituents. Those representing the various opposition groups are naturally more narrowly focused on their members.

It is as right for interest groups to take the micro perspective as it is for policymakers to take the macro perspective. Although far too often the special interest groups prevail because they are much more motivated to keep their concentrated benefits than are the taxpayers who bear the concentrated costs—primarily because they are more informed of changes that affect their interests. Just look at who is represented here today.

Though at times it is difficult to hear past the noise and saber rattling in the Capitol building, we must listen to the voices of average, hardworking citizens who are quietly going about their business to earn a living and pay their taxes that we are charged to spend wisely.

Because some opponents of further pension reform seem intent on spreading misinformation, it is my hope that forums like this disseminate accurate information to the public so good policy that is in the best interest of all Oklahomans can emerge.

I will begin by giving a brief overview

of Oklahoma's collective pension position and our history with funding the actuarially required contribution. Then I will present the factors motivating further pension reform, before restating the framework of the two pension initiatives proposed last session by Governor Fallin. I will close by addressing some of the inaccuracies and misconceptions currently circulating.

Current Status

Collectively, our pension funds are 65 percent funded with over \$11 billion in debt. TRS and Fire have the worst funded status at 55 percent and 61 percent respectively. Investment returns have been adequate to excellent and fees paid to investment managers range from low to high. TRS has significantly outperformed peers with fees in the lower mid range while Police and Fire have under performed over the last five years with above average fees. PERS has performed well with exceptionally low fees.

One should not confuse investment performance with soundness or funded status. While all the plans have earned positive investment returns since the economic recovery began, Judges, Police and PERS are the only plans besting the 80 percent funded status, the commonly accepted minimum threshold for soundness. The sheer size of the TRS unfunded liabilities are a significant drag on the aggregate funded status of all plans.

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We arrived at this unenviable position primarily due to two reasons: legislative mandates that granted cost of living adjustments without the funding to pay for them and a habitual failure to meet the actuarially required contribution (ARC), which is calculated as the sum of the annual normal cost plus a payment to amortize the Unfunded

Actuarial Accrued Liability (UAAL) over a period of no more than 30 years. To my knowledge, the only time Oklahoma's ARC was met on a collective basis was last year and that was due to high, but unsustainable, investment returns. Typically, the

state has met only about 70 percent of the ARC. This, combined with unfunded cost-of-living adjustments, helped create the billions in unfunded liabilities that we now face.

Also problematic is that most state pension plans are dependent on various dedicated revenue streams, which make funding a function of collections rather than appropriations and makes hitting the ARC a matter of chance.

By now, most of us have heard from the opposition groups that everything is fine and no additional pension reforms are needed... only more money. Just last week a left-leaning Oklahoma think tank declared the pension crisis is over, or will be in 22 to 30 years.

So why then has the state's chief executive and chief financial officer been advocating for reforms? It is not as sinister and sensational as the opposition groups would lead you believe. No, it is much simpler than that. Beside the positive elements like fairness, portability, flexibility, and cost certainty associated with 401(k) -style retirement plans that have led younger workers to request such a plan, there are three primary motivating elements: 1)

limited revenues and competing priorities, 2) new GASB rules, and 3) rating agency changes.

Limited Resources

Each year, state agencies request \$2 billion more than is actually appropriated in the GA bill. As you are

well aware, many core functions remain underfunded and the cost of delivering these services is increasing rapidly, especially in areas such as health care, education, and transportation infrastructure.

With tremendous competition for limited resources, the state will not be able to adequately fund core services without containing pension costs. Many in state government are quick to criticize Washington politicians for overspending and saddling the next generation with debt, yet by consistently not meeting the ARC, many of those critics are complicit in doing the same thing by overpromising retirement benefits today

and leaving the debt for somebody else to deal with tomorrow.

Because I expect that later today you will hear from the OEA about all the dangers of pension reform, let's use common education as an example. Common education receives about 35 percent of state appropriations. The larger the amount spent on the back end for retirement, the less will be available on the front end for classrooms and teacher salaries. The defined contribution plan design would only affect future hires, but could provide for increased funding for current classrooms and teacher salaries.

Rather than "changing the pension system on the backs of teachers... to save the state money" as the OEA has alleged, I do not believe the share of state dollars going to education should be reduced, but allocated more effectively to provide a fair retirement, better take-home pay and more money for the classroom. That is why I believe that the OEA is actually working against the best interest of their declining membership by fighting changes that could lead to more money for classrooms, teachers and COLAs now.

GASB rule changes

Because of the pension debt pandemic across the United States, The Governmental Accounting Standards Board (GASB) has implemented pension accounting reforms meant to reduce risk and encourage plan sponsors to address pension debt more prudently.

Most importantly, for the first time pension liability will be shown on the

“(With this plan,) the state could live within its means without balancing its books on the backs of future generations.”

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face of every government's financial statements. For governments that are members of cost-sharing plans like Oklahoma, their portion of pension liability will be shown on their financial statements for the first time. Ironically, those opposition groups who do not want state officials meddling with their pension assets, are completely fine with the state assuming all the pension liabilities.

Rating Agencies

The new GASB reporting requirements have led to changes in how the rating agencies now assess states' pension liabilities and their overall debt levels. All rating agencies will take unfunded pension debt into account when formulating states' credit ratings — a move that has already had an adverse affect on struggling states and could negatively affect our rating without further reforms. Our pension debt remains the biggest obstacle to Oklahoma obtaining a AAA credit rating, an event which could lower our cost of debt and make resources available for investment.

A low credit rating makes it harder and more expensive for a government to borrow money, since it causes higher interest rates as investors try to avoid risk.

Reform proposals

Last February, Governor Fallin proposed two important pension reform goals:

She proposed modernizing our pension benefit plans to provide portability, flexibility and choice to future workers and allow for reduced cost and increased

certainty to the state. And, she proposed streamlining the administration of Oklahoma's pension boards.

Last session, I strongly believed the governor's pension goals were in the best interest of the public and I still do. I appreciate her bold leadership on this difficult and sensitive policy issue.

To meet the needs of a modern workforce we must catch up with the private sector and many other states by moving toward a 401(k)-style retirement plan for non-hazardous duty workers that provides portability, flexibility and choice. It would also be fairer to the taxpayers who largely fund public retirements, most of whom have an employer-sponsored DC plan, if they are lucky.

Such a plan could take the form of a traditional defined contribution plan or a hybrid model. This would allow workers to earn benefits sooner and to take those benefits with them as their careers evolve. It would also reduce cost and increase certainty to state government outlays, enabling more investment today. Further, the state could live within its means without balancing its books on the backs of future generations.

Currently, Oklahoma has seven pension plans, six of which have independent boards, staff, offices, consultants and investment managers—the judges plan already shares administrative functions with PERS. Oklahoma spends \$80 million to \$100 million each year just to administer our pensions. I first anticipated streamlining would result in annual cost savings of approximately 15 percent, yielding about \$120 million to \$150 million in savings over a ten-year period. Since that estimate was immediately dismissed by opposition groups as biased and exaggerated,

NEPC, the State Pension Commission's consultant, was asked to analyze historical data to estimate potential savings. Its report showed savings of between \$15 million and \$50 million per year depending on investment strategy pursued. Of course, that estimate was also dismissed by the opposition groups as biased and exaggerated. It should be noted that these groups did not disprove the math, just simply stated their belief that the assumptions were unrealistic. Regardless of rumors to the contrary, NEPC stands by its report, which clearly states that past performance is not a guarantee of future results.

The NEPC summary reads as follows:

“Common sense and the above scenarios both suggest that significant savings in investment management fees could be achieved by combining the plans. While it appears historically that the active management approach with alternatives generated significant incremental wealth for the Oklahoma Teachers plan, it is not possible to draw “hard and fast” conclusions on expected results in the future. All a reasonable, knowledgeable observer could suggest is that regardless of the investment strategy pursued, there would be some significant cost savings achieved by combining the plans from operational economies of scale, such as less staff (not covered in this memo), and considerable efficiencies in investment management fees from scale.”

Interestingly, I just received an email from a retired teacher from Norman, acting on another OEA alert that warned against any changes to TRS, stating that their retirement plan is one of the best in the US and will be self-sufficient in only 20 years...not really my definition

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of success. In his email he told me that the best way to predict the future is by studying the past. Well that is what NEPC did in its analysis. But, if you don't want to rely on their numbers, fine. If you don't want to rely on my estimate, fine. Rely on your common sense or ask your constituents their opinion on duplication and inefficiency.

Most running for office like to tout their fiscal conservatism and advocate for smaller, more efficient government. You are not likely to find a better opportunity than this to prove such rhetoric. Whether the cost savings is \$50 million or \$10 million, most of our taxpayers would agree that it is efficiency worth pursuing.

Perhaps more important than the significant cost savings, a reconstructed board that included all stakeholders would direct the focus on the financial health of the state and the pension systems as a whole and provide more accountability over the state's balance sheet. A unified pensions system would not mean that the seven plans' funds would be combined, in fact that is prohibited by law and federal tax code – only the funds' administration, investment and financial oversight would be streamlined.

Thirty-six states already have some form of unified pension system, including some of the best-performing states. Tennessee consolidated its seven pension systems into one in 1972, and is currently funded at more than 90 percent. Fitch Ratings recently ranked Tennessee as the state with the lowest debt ratio in the nation when factoring unfunded pension liabilities and net tax-supported debt. And yet, Tennessee still

enacted a lower-cost pension plan for employees starting in fiscal year 2014.

Wisconsin administers one pension plan for nearly all its public workers, excluding only Milwaukee city and county workers. According to Morningstar's annual public pension report, "The State of State Pension Plans 2013," Wisconsin has the strongest public pension in the nation, funded at 99.9 percent.

Washington State originally had six retirement systems, all housed in separate facilities and administered by separate boards. In 1976, to consolidate operations and to improve the overall administration, the individual systems were brought together into a single agency. The Washington State Department of Retirement Systems, whose director is appointed by the governor, has one governing board for all public workers except volunteer public safety workers. Its retirement system is one of the best funded in the nation at 98.1 percent.

Addressing Inaccuracies and Purposeful Misinformation

Based on my experience in state finance, I firmly believe that it is in the best interest of the state to pursue the reform goals stated in my testimony today. But, I also believe that reasonable people can disagree on the merits of the proposal.

What I find unfortunate is when opposition groups attack individuals and motives rather than the merits. I also find it unfortunate when rumors are spread as fact and misinformation is purposefully disseminated to elicit a negative response and engagement. Such inaccuracies serve to instill unnecessary fear and undermine the public trust. Further, it is an insult to the intelligence

of their own group members.

For instance: OEA distributed an email which erroneously stated that the Fallin/Miller pension proposal would base the defined benefit plan for current employees on the first three-year salary average rather than the last three years. When confronted, they denied that such an email had been sent from their office until presented with a copy.

The Firefighter's association representatives wrote that the intent of pension reform was to lower taxes for the rich and reduce widow's benefits. They are actively promoting that I have partnered with an "Enron billionaire from Texas" that I have never met nor talked with. Mr. Ostrander testified to the House committee last month that in a speech I made in Rhode Island, I committed to closing the defined benefit plan for public safety workers. None of these claims are true.

It has been said I don't think teaching is a real career, when I, myself, am a teacher. That I believe teacher retirement benefits are currently too rich, when I said that they are a benefit that our pension debt proves the state has been unwilling to afford.

The opposition group distributed a letter filled with mistruths, class warfare and efforts to pit the legislative branch against the executive branch. Here are a couple of excerpts from the letter:

In August, the opposition group Keep Oklahoma's Promises released a communication stating, and I quote, "Fallin's pension plan comes straight from the books of Wall Street and special interest lobbyists. Fallin has partnered behind closed doors with big-money outsiders and hedge fund

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Gross receipts & General Revenue compared

The Treasurer's October 3 gross receipts to the treasury report and the Office of Management and Enterprise Services' October 14 General Revenue Fund (GRF) report contain several differences.

September gross receipts totaled \$1.01 billion, while the GRF received \$505.8 million or 50.2 percent of the total.

The GRF received between 32.2 percent to 57.3 percent of gross collections during the past 12 months.

From September gross receipts, the GRF received:

- Personal income tax: 67.9%
- Corporate income tax: 57%
- Sales tax: 44%
- Gross production-Gas: 45.1%
- Gross production-Oil: 0%
- Motor vehicle tax: 28%
- Other sources: 51.6%

September GRF allocations missed the estimate by \$54.7 million or 9.8 percent. In August, collections topped the estimate by \$73.4 million or 17.4 percent.

For the month, insurance premium taxes totaled \$48.9 million.

Tribal gaming fees generated \$10.8 million during September.

12-month gross receipts to the treasury continue unprecedented climb

For a third consecutive month, 12-month collections reached a new high, State Treasurer Ken Miller announced as he released the September gross receipts to the treasury report.

Twelve-month collections at the end of September topped \$11.33 billion, up by almost \$20 million from August's total. Until July of this year, the 12-month record

high had stood since December 2008 – four years and seven months. The latest twelve-month gross receipts rolling average stands at 3 percent for the period.

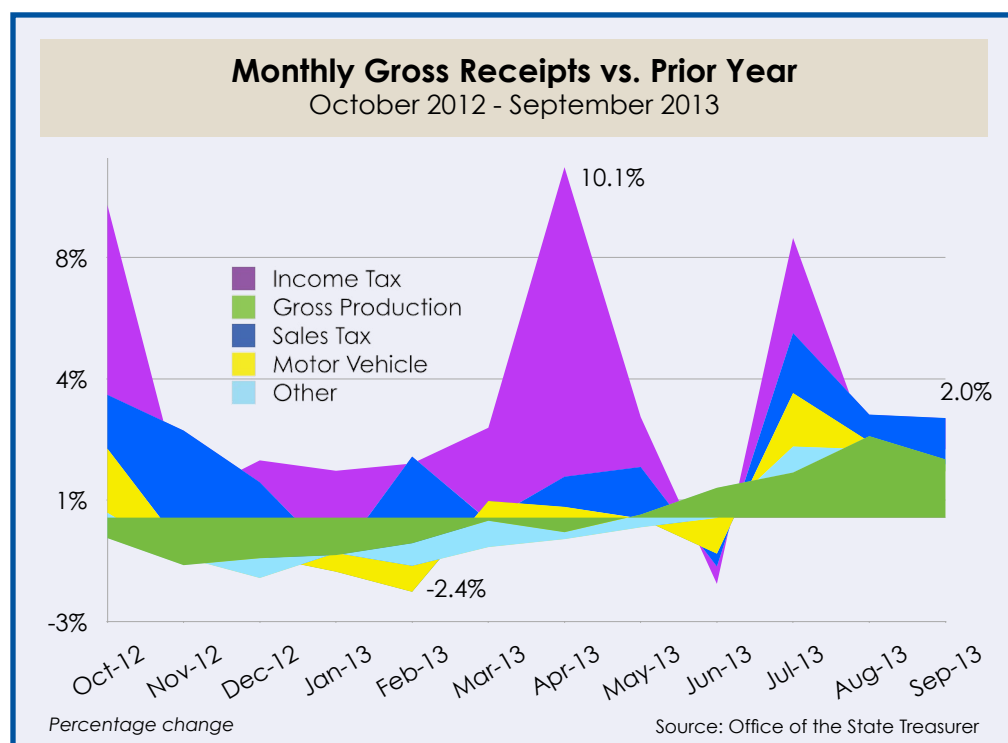
“As measured by state revenue collections, Oklahoma’s economy continues its climb up the expansion side of the business cycle,” said Miller.

“Oklahoma’s economy continues its climb up the expansion side of the business cycle.”

Collections on the production of oil and natural gas were the most improved component of the monthly report, up by more than 31 percent over September of last year.

“The turnaround in gross production tax collections – up over the prior year for the fifth month in a row – is most encouraging,” he said. “After 17 months of falling gross production numbers, it’s

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managers who want to send the life savings of working Oklahomans to the same Wall Street gamblers who crashed our economy in the first place. Under *Fallin's* plan..." and it goes on.

In September, the very same opposition group released a communication stating, and I quote, "*Miller's* pension plan comes straight from the books of Wall Street and special interest lobbyists. *Miller* has partnered behind closed doors with big-money outsiders who want to send the life savings of working Oklahomans to the same Wall Street gamblers who crashed our economy in the first place. Under *Miller's* plan..." and it goes on.

I guess it took them a month to figure out that Governor Fallin has a 70-percent approval rating and is pretty hard to vilify.

Other inaccuracies include:

Transition Cost

Claims that a transition to a less costly DC system would be cost prohibitive are a false scare tactic. Our goal is to strengthen state finances, not harm them. According to statute, all pension changes must be reviewed by an actuary and cannot move forward in the current legislative session if the changes adversely impact the system.

Further, with a lower-cost system in place for new workers, and with all current funding for employee retirement benefits maintained, savings could be applied to the pension debt, paying off our obligations sooner. Once pension obligations are reduced or eliminated, funds dedicated to employee

compensation can be used to fund COLAs or for increased compensation.

Power Grab

In most states and in a corporate setting, the CEO and CFO are involved with all financial statement items, especially the largest debt item on the balance sheet, but in Oklahoma politics it's considered a power grab.

This is not about the governor or me. I do not need the power, the extra work or the headache – I have already been entrusted with billions of dollars by the voters. Besides, all of us are temporary inhabitants of our respective offices. This is about good government for the long-term fiscal health of the state.

I simply believe that the governor and treasurer in our state, who are duly elected and accountable to all our citizens, have implicit and explicit fiduciary duties in regard to pension debt, the largest item on our balance sheet, just as our counterparts do in most other states.

Wall Street

It has been alleged that there is a great conspiracy behind pension reform efforts to benefit Wall Street. I believe that investment managers already make too much money off Oklahoma pension assets, which is why we are trying to reduce their fees under a unified system...hardly pandering.

I would like to believe that those making these personal attacks and spreading purposeful misinformation feel some sense of embarrassment or shame.

Unfortunately, it appears some opposition groups subscribe to the "win by any means necessary" strategy. And,

I can't blame them, if these tactics are allowed to succeed.

Conclusion

As with many past efforts in state government, there will always be those who fight to maintain the status quo. You will hear from many of them later today.

I believe that now is the time to address our unfunded pension debt, eliminate inefficiencies, reduce administrative cost and develop a fiscally responsible benefit structure for the future. But it cannot be done without the Legislature.

If we do not address our pension debt, the consequences will be one of three options: Taxpayers will pay more, employees will pay more, or state funding to other areas and services will be cut.

I stand ready to assist you anyway that I can to finally deliver a responsible, fully funded pension.

Again, thank you for the opportunity to be here today. I am happy to take questions.

Revenue

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good to see the positive trend and the effects it has on our state and businesses."

Personal income and sales tax collections are also higher than the prior year. Only corporate income and motor vehicle taxes were lower than a year earlier.

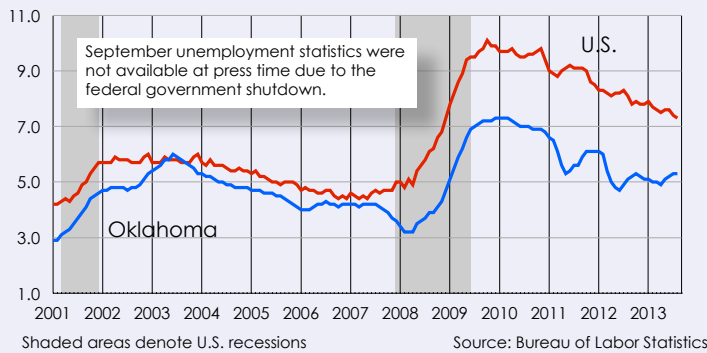
Miller pointed out that the record high numbers take into account a quarter-point cut in the personal income tax rate.



Economic Indicators

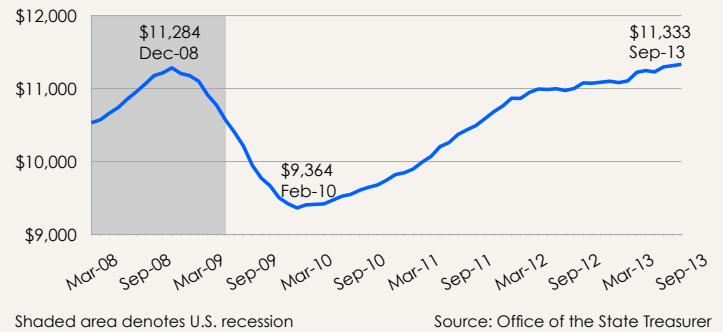
Unemployment Rate

January 2001 – September 2013

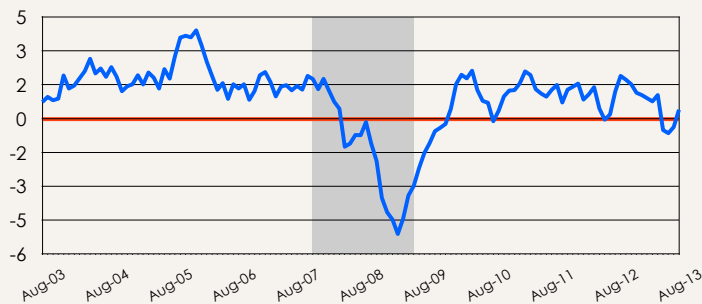


Oklahoma 12-Month Gross Receipts

March 2008 - September 2013
(in millions)



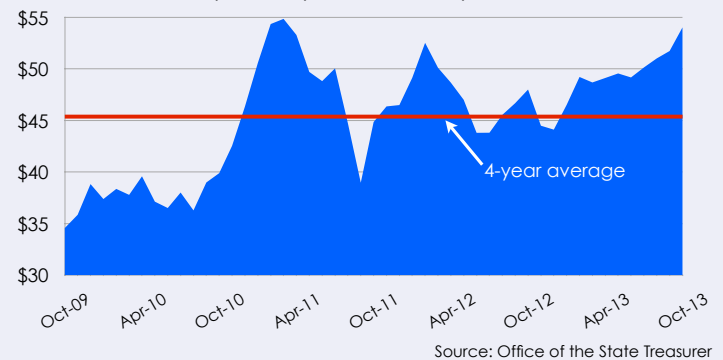
Leading Index for Oklahoma



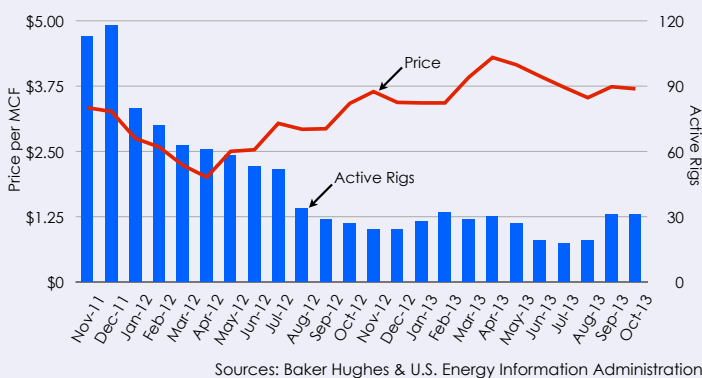
This graph predicts six-month growth by tracking leading indicators of the state economy including initial unemployment claims, interest rate spreads, manufacturing and earnings.

Oklahoma Stock Index

Top 25 capitalized companies



Oklahoma Natural Gas Prices & Active Rigs



Oklahoma Oil Prices & Active Rigs

